International Business Environments and Operations, 13/e

Part 4

World Financial Environment



Chapter 9

Global Foreign Exchange Markets

Chapter Objectives

- To learn the fundamentals of foreign exchange
- To identify the major characteristics of the foreign-exchange market and how governments control the flow of currencies across national borders
- To describe how the foreign-exchange market works
- To examine the different institutions that deal in foreign exchange
- To understand why companies deal in foreign exchange

What is Foreign Exchange?

- Money denominated in the currency of another nation or group of nations
- Can be in the form of cash, funds available on credit and debit cards, traveler’s checks, bank deposits, or other short-term claims
- An **exchange rate** is the price of a currency

Players on the Foreign Exchange Market

The Bank for International Settlements divides the foreign-exchange market into reporting dealers (also known as dealer banks or money center banks), other financial institutions, and non-financial institutions.

Aspects of the Foreign Exchange Market

- Over-the-counter (OTC) commercial and investment banks.
- Securities exchanges
  – CME, NASDAQ OMX, NYSE Liffe

Traditional Foreign Exchange Instruments

- Spot Transactions
- Outright Forward Transactions
- FX Swap
- Currency Swaps
- Options
- Futures Contract

Size, Composition, and Location of the Foreign Exchange Market

- Size of the foreign-exchange market—$3.2 trillion daily
- The U.S. dollar is the most important currency on the foreign-exchange market
- Frequently Traded Currency Pairs
  - Top two pairs include EUR/USD and USD/JPY

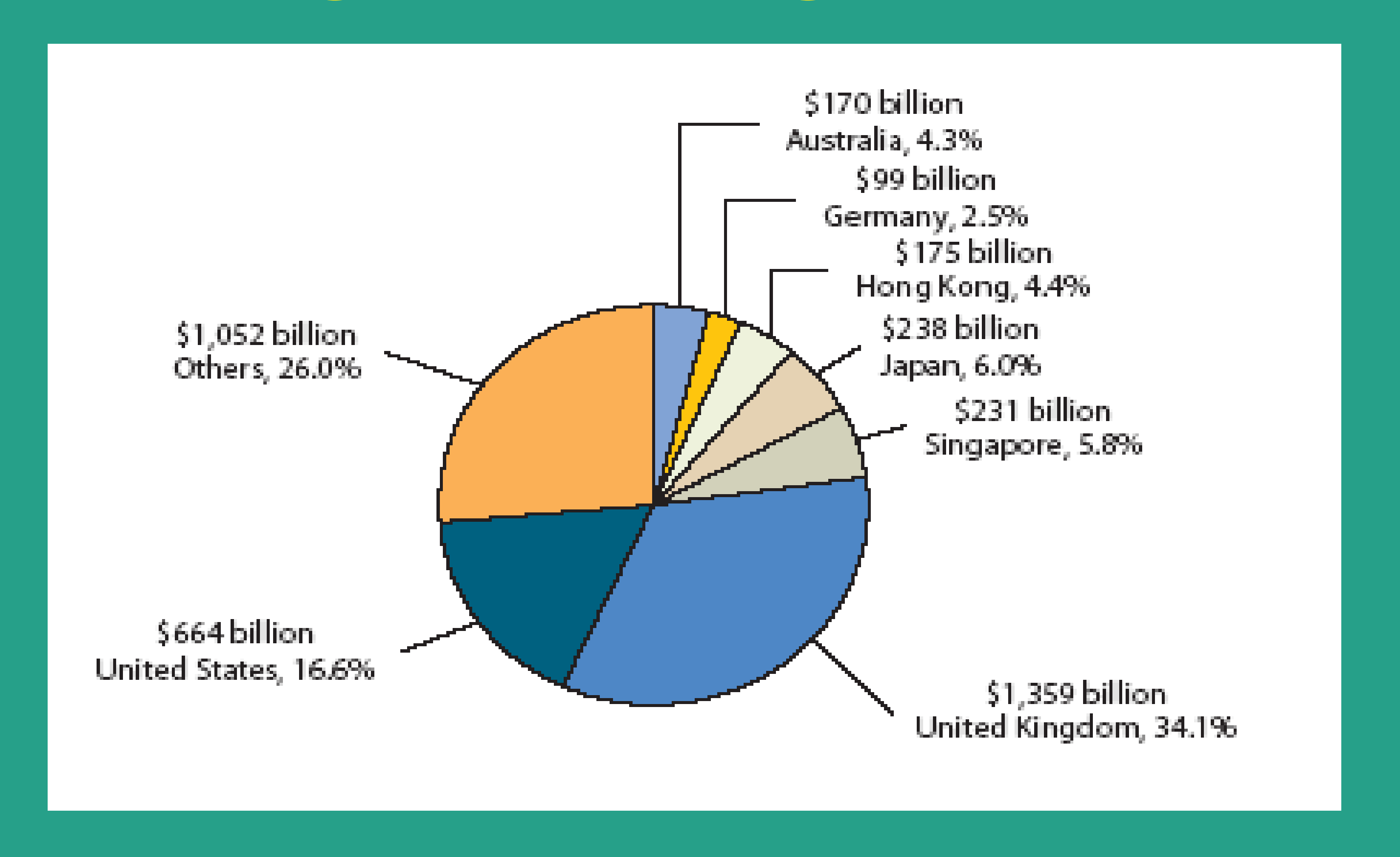
Global Foreign Exchange: Currency Distribution

The U.S. dollar is involved in a whopping 86.3 percent of all worldwide foreign-exchange transactions. Because it's so readily available, it's a popular choice for exchanges between two countries other than the United States, and it's involved in four of the seven most frequently traded currency pairs (the $/€ is number one, the $/¥ number two).

Currency	April 1992	April 1995	April 1998	April 1998	April 2001	April 2007
U.S. dollar	82.0%	83.3%	87.3%	90.3%	88.7%	86.3%
Euro	—	—	—	37.6	37.2	37.0
Japanese yen	23.4	24.1	20.2	22.7	20.3	16.5
Pound sterling	13.6	9.4	11.0	13.2	16.9	15.0
Swiss franc	8.4	7.3	7.1	6.1	6.1	6.8
All others	72.6	75.9	74.4	30.1	30.8	38.4

Source: Bank for International Settlements, *Central Bank Survey of Foreign Exchange and Derivatives Market Activity, 2007* (Basel, Switzerland: BIS, December 2007): 11. Reprinted by permission of the Bank for International Settlements.

Geographical Distribution of Foreign Exchange Markets



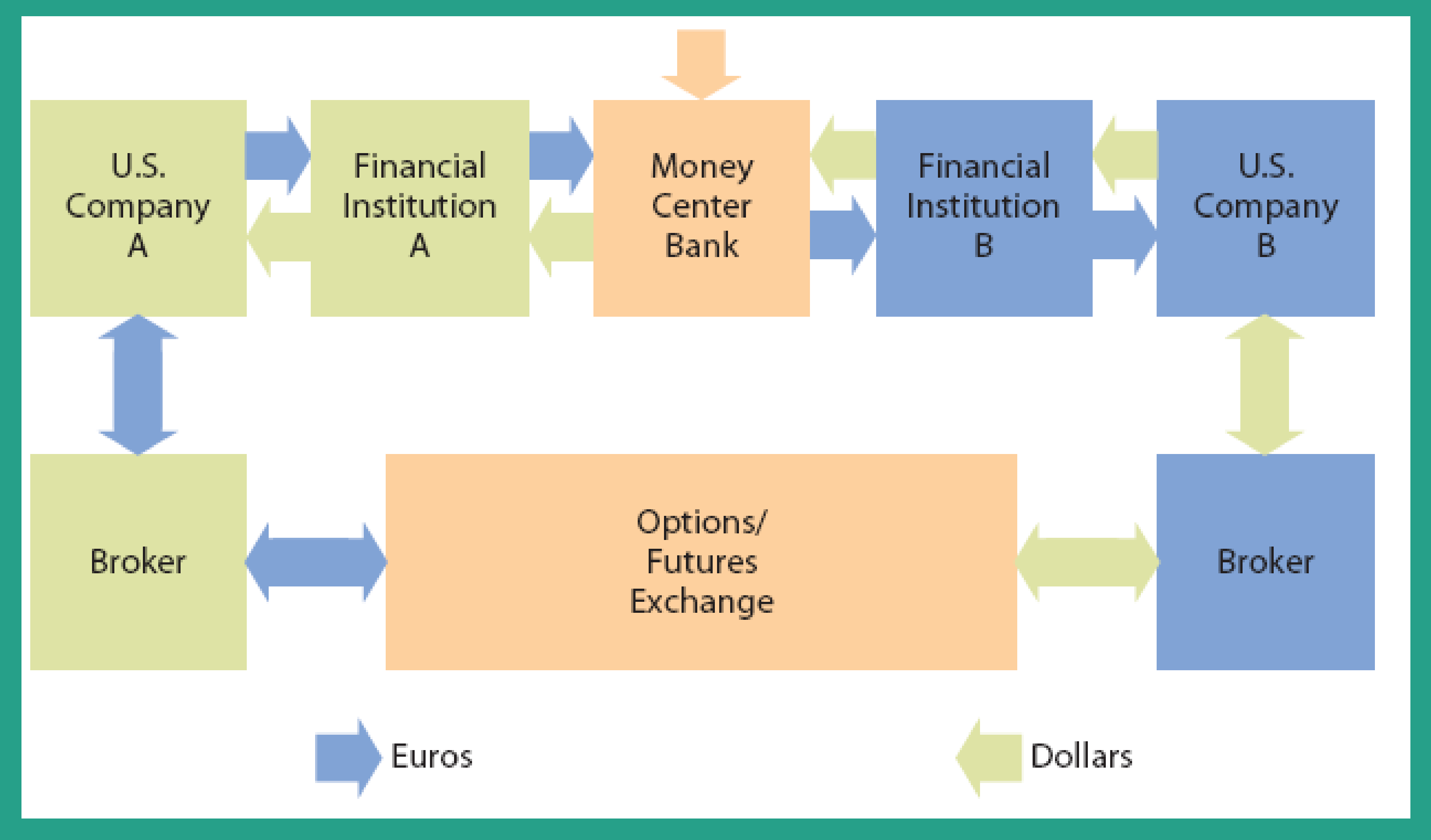
The Spot Market

- Direct and Indirect Quotas
- Base and Term Currencies
- Inter-bank Transactions

The Forward Market

- Forward Discounts-exist when the forward rate is less than the spot rate.
- Forward Premiums-exist when the forward rate is greater than the spot rate.
- Option-the right, but not the obligation, to trade a foreign currency at a specific exchange rate.
- Futures-specifies an exchange rate in advance of the actual exchange of currency

The Foreign Exchange Trading Process



Banks and Exchanges

- The top banks in the inter-bank market in foreign exchange are so ranked because of their ability to
  - Trade in specific market locations.
  - Engage in major currencies and cross-trades.
  - Deal in specific currencies.
  - Handle derivatives (forwards, options, futures, swaps).
  - Conduct key market research.

Foreign-Exchange Trades: Top Commercial and Investment Banks, 2009 as Ranked by Overall Market Share

Trading Bank	Estimated Market Share %	Best in Euro/$	Best in $/Pound	Best in Euro/Pound	Best in $/Yen
1. Deutsche Bank	20.96%	1	1	1	1
2. UBS	14.58%	3	4	3	3
3. Barclays Capital	10.45%	5	2	2	5
4. RBS	8.19%				
5. Citi	7.32%	2	5	5	2
6. JP Morgan	5.43%				
7. HSBC	4.09%	4	3	4	4
8. Goldman Sachs	3.35%				
9. Credit Suisse	3.05%				
10. BNP Paridas	2.26%				

*Estimated Market Share source: "FX Poll 2009: Overall Market Share," Euromoney (May 2009) and Best in Currency source: "FX Poll 2008: Best for Currencies," Euromoney (May 2008)

Top Exchanges for Trading Foreign Exchange

Firms can also use securities exchanges for derivatives trade in foreign exchange.

- CME Group
- NASDAQ OMX
- NYSE Liffe

Future: Where are foreign exchange markets headed?

- Restrictions to the free flow of goods and services should diminish
- Technological developments cause foreign exchange trades to be executed more quickly and cheaply.
- Internet trade will increase currency price transparency and increase the ease of trading, thus allowing more investors into the market.

How Companies Use Foreign Exchange

- Cash Flow Aspects of Imports and Exports
  - Commercial Bills of Exchange
  - Letters of Credit
- Other Financial Flows
  - Speculation
  - Arbitrage